

Rating Update: [Alabama \(State of\)](#)

RATING UPDATE: MOODY'S UPGRADES ALABAMA GENERAL OBLIGATION DEBT TO Aa2 FROM Aa3

OUTLOOK STABLE; \$486.5 MLN OF G.O. DEBT AND \$1.59 BLN OF REVENUE BONDS AFFECTED

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Opinion

NEW YORK, Aug 26, 2005 -- Moody's Investors Service has raised the State of Alabama's general obligation debt rating to Aa2 with a stable outlook. The upgrade reflects the growing importance Moody's rating methodology assigns to state financial management practices, and a recognition that Alabama's strength in this area compensates for its economic weakness relative to other states. The action affects about \$2.1 billion of outstanding debt including \$486.5 million of general obligation debt and \$1.59 billion of Alabama Public School and College Authority debt.

Credit strengths:

- Strong financial management practices as evidenced in record of positive operating fund balances
- Constitutional as well as statutory basis for requirements that drive state's prudent financial management
- Financial recovery underway, with revenues exceeding estimates and declining reliance on non-recurring measures
- Signs of economic progress linked to growing non-durable goods manufacturing sector

Credit challenges:

- Long-running economic weaknesses including high poverty levels, manufacturing job losses, and below-average population growth
- Financial pressure from healthcare costs (including Medicaid and employee and retiree health benefits programs) K-12 and other programs

ALABAMA'S REQUIREMENTS FOR SPENDING CONTROLS AMONG THE STRONGEST OF ALL STATES

Alabama's financial strength stems from the executive branch's obligation to monitor revenue and spending and to impose cuts pro-rata against eligible appropriations, when needed, in response to revenue shortfalls. This action, known as proration, is provided for in both constitution and statute, and it has a long history of sustaining the state's financial health through periods of both recession and expansion. During the last four fiscal years, when the budgetary stress of a national recession was exacerbated by Alabama voters' rejection of a tax overhaul proposed by the governor, the state maintained combined operating fund balances that were positive under Generally Accepted Accounting Principles (or GAAP). In this important way, Alabama showed financial results stronger than those of many states.

STATE RATING METHODOLOGY ATTACHES INCREASING IMPORTANCE TO MANAGEMENT AND FINANCES

Moody's on Feb. 1 placed Alabama's ratings on Watchlist for a possible upgrade. The resolution of this review was deferred, pending a special legislative session, in late July, to adopt a general fund budget for the fiscal year starting Oct. 1. Alabama's history of ample GAAP balances was an important factor in assigning the higher rating, and the change is consistent with the increased emphasis that Moody's state rating methodology places on management attributes and financial performance measures (as opposed to debt burden or economic factors). However, Alabama's management profile is somewhat undermined by the absence of features characteristic of highly rated states, such as provisions for multi-year budget forecasting,

government-wide debt affordability analysis, and consensus revenue estimates agreed to (and binding upon) the executive and legislative branches of government. The state's financial flexibility is also constrained to some extent by its wide use of earmarking revenues for specific purposes. Yet these weaknesses are less consequential in this case than they would be for a state lacking Alabama's constitutional and legal requirements to maintain balanced operations.

CONSTITUTIONAL AND LEGAL BASIS FOR MANAGEMENT STRENGTH

Amendment 26 to the Constitution of Alabama was enacted to prevent deficit spending by allowing expenditures only from appropriated funds on hand in the state treasury. This measure also stipulates that if available funds are less than spending requests at fiscal year-end, the funding granted for the requests must be cut in proportion with the shortfall overall, and any unpaid appropriations must be voided. Amendment 26 is supplemented by a 1932 state law that directs the governor to restrict appropriated fund allotments across the board, in proportion with any revenue shortfall projected by the executive branch department of finance. The law requires the governor to use this power so that the state does not encounter the sort of fiscal year-end deficit that, under Amendment 26, would interrupt the state's ability to make payments. The Alabama Supreme Court has determined that the statute does not apply to payment obligations exempted under statute or that are constitutionally mandated. This description includes debt service payments on state general obligation and revenue bonds. The statute has a long history of use, having been invoked about two dozen times since it was adopted seven decades ago. The most recent instance was two years ago, when the governor declared a 4.4% proration of Education Trust Fund spending, amounting to \$185 million.

RAINY DAY ACCOUNT FOR EDUCATION TRUST FUND PROVIDES INTERNAL LIQUIDITY SOURCE

Most of this prorated amount, or about \$180 million, was covered using the Education Trust Fund Rainy Day Account, an internal liquidity source that was created in 2002, following a constitutional amendment. The account's purpose is to shield K-12 funding from cuts that occur under the state's proration laws. The account is part of the Alabama Trust Fund, a \$2.4 billion reserve formed from payments to the state for rights to seek and extract undersea gas and oil deposits. Borrowings from the account must be repaid within five years, and the state has begun the process of repaying the 2003 borrowing in equal installments.

FISCAL 2005 REVENUES ARE EXCEEDING FORECAST, THOUGH MEDICAID COST GROWTH AND OTHER PRESSURES REMAIN

Revenues in the current October-to-September fiscal year were well ahead of estimates through July. Collections of the Education Trust Fund, primarily income and sales tax receipts, totaled \$4.0 billion, or 5.3% more than projected. The general fund's collections (from sources including insurance company fees, a cigarette tax, and a statewide ad valorem tax) amounted to \$1.1 billion, or 4.5% more than forecast. Overall revenue growth, at about 11% compared with year-earlier collections, is helping the state curb its use of non-recurring budgetary measures. Alabama still faces significant financial challenges, most notably Medicaid's growing burden on the general fund. Medicaid appropriations account for about a quarter of the current fiscal year's general fund spending authority. Medicaid expenditure growth contributed to an anticipated general fund budget gap for fiscal 2006 that was addressed through a combination of spending cuts, increased revenue growth estimates, and non-recurring use of tobacco company legal settlement payments.

ECONOMIC WEAKNESS STILL DETRACTS FROM ALABAMA'S OVERALL CREDIT QUALITY

Alabama's economy still tends to under-perform the nation's, and this reflects conditions such as acute poverty, low levels of educational attainment, and the state's continuing losses of non-durable goods manufacturing businesses. Even here, however, the state is making some progress. The state's economy resumed adding jobs in 2004. Non-farm employment trends in the state have improved, and growth is essentially in line with the national pace, ending a six-year period in which the state substantially lagged the nation. The state's four auto assembly operations -- Honda Manufacturing of Alabama LLC, Hyundai Motor Manufacturing Alabama LLC, Mercedes-Benz U.S. International Inc., and Toyota Motor Manufacturing Alabama -- appear to have added significantly to manufacturing employment. While job losses in manufacturing overall have persisted, the pace of losses in 2004 slowed to 1%, down from a high of 7.4% in 2001. Also, the state's durable goods manufacturing sector added jobs in 2004 for the first time since 1998, according to Bureau of Labor Statistics data.

STATE'S APPROACH TO BORROWING HAS BEEN LARGELY CONSERVATIVE

Conservative tendencies for the most part have governed Alabama's use of debt. The state's general obligation borrowings must be authorized by a popular vote and three-fifths majority in the legislature. Net tax-supported debt amounts to 2.0% of personal income (compared with the national median of 2.4%), and \$523 per capita (compared with a national median of \$703). Growth in the state's debt has been slow in recent years, but it may accelerate if the state authorizes additional bonding for the Alabama Public School and College Authority.

PENSION OBLIGATIONS INCREASE; STATE MAKES INCREASED USE OF SWAP AGREEMENTS

Alabama's unfunded pension obligations are increasing, as stock-market losses are phased in over a five-year smoothing period, but they are still at healthy levels compared with many other states. The Teachers Retirement System of Alabama's funded ratio fell to 93.6% as of June 30, 2003, from 101.4% two years earlier. The Employees' Retirement System of Alabama's funded ratio was 91.1% as of Sept. 30, 2003, down from 100.2% two years earlier. The state also faces liabilities for retiree health benefits, but it was one of the first states to pass legislation to address this issue. The measure, passed last year, subjects state workers to larger premium burdens if they retire early or if they smoke. In addition, the law gave health plans' boards authority to revise the plans without specific legislative authorization.

Finally, Moody's notes that the state in recent years has entered several interest-rate swap agreements or swaptions that provided up-front payments. The most recent, entered in June 2004, generated a payment of \$19.7 million. Two prior agreements, entered in 2002, generated payments of about \$18 million combined. Moody's views the increased costs that may result from these agreements over time as within the state's financial capacity. At the same time, the amount of debt that is or would be subject to these agreements corresponds to a relatively high portion (47%) of the state's total net tax-supported debt.

Outlook

The outlook for the state of Alabama's rating is stable, based on the strong statutory and constitutional requirements that force officials to cut expenditures to meet revenues when necessary.

What could move the rating up:

-- Sustained trend of private-sector job creation meeting or exceeding national pace and development of new industrial base, with per-capita personal income levels nearing national level

-- Adoption of best-practices financial management techniques such as government-wide debt analyses and binding consensus revenue forecasting

What could change the rating -- DOWN

-- Increased reliance on non-recurring revenue sources for operating purposes

-- Intensifying fiscal stress from any source, including Medicaid, retiree benefit funding or other programs, or from other sources such as litigation or financial market commitments

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